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Friday, February 17, 2006

Opposes Kentucky 'flat tax' for tobacco

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Kentucky needs all the revenue it can get. Our legislators and our Governor should leave no stone unturned as they look for ways to increase funds available to benefit Kentucky citizens. There is no dispute about that. Maximizing revenue combined with fiscal responsibility is the way to keep our state on the road to financial health.

But the "tobacco flat tax" proposal supported in this paper's editorial of Feb. 6 is nothing but "fool's gold." The Governor, at the urging of a group of tobacco companies that did not sign the Master Settlement Agreement (MSA), is asking the legislature to impose a tax on tobacco to replace the MSA that the commonwealth signed in 1998. Supporters of the flat tax on tobacco argue that it is fair, reasonable, and presents no risk. In fact, it's anything but.

There are several reasons why it makes no sense for Kentucky to enact this proposal. The proposal would breach the MSA -- which is a contract like any other contract -- and doing so is unconstitutional. A party cannot unilaterally decide to "improve" contract terms it agreed to. The proposal would also embroil Kentucky in years of litigation with the manufacturers who are parties to the MSA. Other states have already recognized the folly in this ploy. Similar initiatives have already come up in 10 states, failing in all 10. Why must that ground be plowed again?

Echoing concerns that a number of companies participating in the MSA have raised, Attorney General Greg Stumbo warned recently that enacting the proposal would "likely result in litigation alleging that such action constituted a repudiation of the entire MSA," and could also "be claimed to violate the constitutional protection of equal protection," because companies that participate in the MSA would be "required to pay the fee on top of their MSA payment." Stumbo did agree that Kentucky retains the sovereign right to tax -- there is no argument about that. But a tax that violates the MSA, as this proposal would do, presents constitutional and contractual issues.

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More important, Stumbo also warned about the potential consequences of this proposal. There is a very real chance that Kentucky will not see a penny of the flat tax and will lose its future MSA payments. What's more troubling, MSA manufacturers will most likely pursue a court order to instruct the commonwealth to refund the MSA money that Kentucky has already received -- and that's more than $735 million.

Such an outcome would be a fiscal disaster for the commonwealth. It would also be disastrous to the programs and services that the MSA money supports: funds for Kentucky farmers and programs focusing on early childhood development, education, cancer research and public health, including smoking cessation. In fact, the commonwealth is even paying debt service on some loans with MSA funds because the money is guaranteed. Why would the legislature ever take action to jeopardize this substantial recurring revenue stream?

It is no answer to say, as this paper did, that the General Assembly should just pass the proposal and let the courts sort it out. That is irresponsible. It would mire hundreds of millions of dollars in Kentucky's budget in risk and uncertainty, and tie up the state's resources in litigation it is very unlikely to win, all in the (vain) hope that there is a pot of gold at the end of the rainbow.

Nor are the Democrats being "obstructionist" on this issue, as the Feb. 6 editorial indicated. In fact, the Democratic House Speaker and other members of leadership have proposed an MSA-related bill that should result in immediate revenue ($25 to $30 million annually) from tobacco manufacturers without all the risks involved in the Governor's proposal. And, if the anti-tax pledge Governor wants to propose a fair and even-handed excise tax, which will be legal and more efficient, he should have the political will to do so.

It is also important to understand who is pushing this proposal, and what they will get out of it. If enacted, the proposal will make some manufacturers (the ones that joined the MSA) pay twice on sales in Kentucky. Others manufacturers -- the NPMs that are behind this scheme -- will only have to pay once.

These NPMs have enjoyed a price advantage over the MSA companies for years because, among other things, they have been able to use a "loophole" that was recently closed. Now that the playing field has been leveled, they are desperately trying to secure a new advantage with the proposed flat tax. The NPMs reap two huge payoffs if their proposal is enacted. First, they will avoid a $30 million escrow payment now required as a result of the MSA loophole being closed. Second, the fact that the MSA manufacturesrs will pay $8 a carton while the NPMs pay only $4 means that they will maintain a price advantage over the MSA manufacturers. That isn't fair by any stretch of the imagination. Is it any wonder that the MSA manufacturers are threatening litigation if the flat tax passes?

The companies pushing this initiative have a clever story to back it up -- one that the Governor and this paper apparently have bought hook, line and sinker. They say that Kentucky got a bad deal in the MSA to start with. They claim Kentucky is paying New York a lot of money that it shouldn't have to pay. The problem with this story is that it is grossly misleading.

Yes, Kentucky gets less money under the MSA than New York and some other states get. But that was a deal that Kentucky and the other states carefully negotiated based on the amount that each state paid for expenses attributable to smoking-related illnesses. The federal Centers for Disease Control report that in 1998, when this deal was negotiated, Kentucky spent about $350 million of its Medicaid expenditures on smoking-related illnesses, while New York spent more than 11 times as much, or $4.27 billion. That's what accounts for the disparity -- not an inequity to Kentucky taxpayers.

Don't buy the story that this proposal isn't an additional tax -- because it is. The manufacturers of 90 percent of the cigarettes sold in Kentucky will be required to pay $4 per carton under this proposal. And the proponents of the law admit that prices to consumers likely will go up if it is passed.

No one argues with a state's sovereign right to tax its citizens, if it does so fairly and doesn't breach a contract by means of a tax. There are also other fair ways to raise revenue, like the proposal that House Democrats just put on the table. But the Governor's scheme is not fair, and it is not safe. Instead of generating incremental tax revenue for Kentucky, this proposal will jeopardize a huge, recurring revenue stream and lead to expensive litigation. The only thing to be panned out of this revenue stream is fool's gold -- period.

Spencer Coates is chairman of Commonwealth Brands, Inc., the fourth largest tobacco manufacturer in

the country, which is headquartered in Bowling Green.

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